PETER D. STERNLIGHT

NOTES FOR FOMC MEETING

NOVEMBER 14-15, 1983

Desk operations since the October meeting sought to achieve the slightly lesser degree of reserve restraint desired by the Committee since mid-September. Monetary aggregates continued to be remarkably well behaved, running just about as desired for M-2 and M-3 and weaker than expected for M-1. Meantime, the economy continued to show strength while inflation remained subdued. What might have been an unusually tranquil period for domestic financial markets was disturbed, however, by failure of the Congress to act on a debt limit increase, causing the Treasury to delay and reshape its financing operations, and probably contributing a bit to a moderate rise in most intermediate and longer term interest rates over the interval.

Weekly nonborrowed reserve objectives aimed consistently for $650 million of adjustment and seasonal borrowing, a measure of restraint that was expected to be associated with Federal funds trading in a 9 1/4-9 1/2 percent range. Actual borrowing levels varied from the objective, running somewhat to the low side through most of the period, but then climbing to a weekly average a little over $1 billion in the latest week, and remaining in that area so far this week. An average for the period would be quite close to the desired $650 million. For the most part, weekly deviations resulted from end-of-week misses in reserve projections. Meantime, weekly average Federal funds rates were exceptionally steady varying by only a few basis points from 9 3/8 percent--a shade below the 9 1/2 percent central tendency through most of September.

The System's portfolio showed little net change in outright holdings for the full period. The Desk purchased about $1 billion of Treasury bills from foreign accounts, but also permitted $700 million of bills to mature without replacement when it appeared for a time that a reserve absorption was in order. That particular bill run-off coincided, fortuitously, with the Treasury's need to cut back on a particular bill auction because of debt ceiling constraints. Soon after we committed for the run-off it was learned that other factors would be draining reserves unexpectedly, so we began rebuilding outright holdings again. Most days in the period saw the Desk either passing through customer repurchase agreements to the market or arranging the System's own agreements. On one day, following an unexpectedly large provision of reserves because of a Reserve Bank operational problem we arranged a large volume of matched sale-purchase transactions in the market.

Interest rates see-sawed under diverse influences during the intermeeting period, mainly ending up with slight to moderate increases. While average Federal funds rates edged off slightly and then held steady, this in itself was a disappointment to some in the market who harbored expectations that funds would drift down toward 9 percent. Disappointment was accentuated when publication of the August policy record failed to disclose reference to a post-meeting decision to seek slightly easier conditions, which some observers assumed had occurred. Adding to market caution, were the reports of stronger than expected business expansion, while later in the period the reshuffling of the Treasury's coupon auction caused concern about the need to compress still-large needs into a shorter period of time. Interspersed with these concerns, though, the continued moderation of the aggregates provided some encouragement, and in the final days of the period, when the Treasury's rescheduled auctions had finally been completed, a more confident feeling emerged in the market. A Desk order to buy nearly $1 billion of coupon issues for a foreign central bank also helped the atmosphere.

On balance, Treasury coupon issues maturing in about two years were scarcely changed in yield for the period, while longer issues rose about 10 to 25 basis points. Dealers have taken on sizable inventories of the just-auctioned November refunding issues but in the better atmosphere of the last couple of days they seem fairly content with them.

In the shorter term sector, Treasury bill rates have changed little on balance since early October. There was a dip in late October when the Treasury slashed its weekly bill offering sharply because of debt limit constraints, but rates soon rebounded as more normal issuance resumed. Three and six-month auction rates today averaged an estimated 8.77 and 8.91 percent, compared with 8.72 and 8.92 percent on October 3. Rates on CDs and commercial paper also changed little over the interval, inching up about 5-15 basis points. There is a barely perceptible widening in the spread of CDs over Treasury bills, but one needs a microscope to see it, and it may have more to do with scarcities of bills than with a shunning of bank obligations. On the other hand, I have heard the comment more than once that if banks were having to place any appreciable reliance on the CD market as a source of funds, we would probably be seeing a considerable widening of spreads reflecting concern about the international loan picture.

As to the market's near-term rate outlook, the bulk of opinion centers on no significant change. A dwindling few are still looking for rate declines in view of the good performance of the aggregates and of inflation, and a feeling that technical factors have recently held rates higher than they ought to be. Another minority group looks for some increase, perhaps by year-end, as credit demands from a strengthening economy come into greater conflict with still excessive Treasury requirements. But most are in the middle, seeing a rough balance of plus and minus factors.

Action on the Treasury's debt limit is expected any day now, but its precise timing is uncertain and without it the Treasury's position remains vulnerable. Unlike other recent debt limit crises, when the immediate reversion to a low permanent ceiling precluded even the possibility of refunding maturing issues, the present situation is one of bumping against the $1,389 billion ceiling enacted in permanent form last spring. Thus rather than facing a clear D-date that would be like a steep precipice, the present situation is more comparable to being mired in a swamp, and hopping from rock to rock for an uncertain while. Tomorrow is a critical date because the Treasury is both up against the debt ceiling and nearly out of cash. On the latest estimates they can just about make it through tomorrow, which should be the cash low point until the opening days of December when a fresh round of outpayments (mostly social security) will exhaust their cash again. Precisely how long they can last into December would depend in part on which special measures, or gimmicks, the Treasury might be able and willing to employ.

Mr. Chairman, present projections of reserve needs for the upcoming intermeeting period indicate that the need for reserve additions might well exhaust the standard $4 billion intermeeting leeway in the Committee's authorization to the Desk. I recommend that the leeway for change in outright holdings between meetings be raised temporarily to $5 billion.

Notes for FOMC Meeting
November 15, 1983

Sam Y. Cross

1. Given the widespread expectations of further declines in the dollar at the time of your last meeting, the dollar has demonstrated surprising strength in the last several weeks. After declining in the first week of October, the dollar reversed course. International disturbances in a number of locations around the world helped to support this strenghtening tendency of the dollar for most of the remainder of the period. Since your last meeting, the dollar rose on balance by about 2 percent against the mark and most other continental currencies, and by a little less than 1 percent against the yen.

2. Renewed evidence of a vigorous recovery in the United States led exchange market participants to doubt there was room for further declines in interest rates. In fact, short-term U.S. interest rates did stop declining and long-term rates rose moderately. At the same time, the eruption of political and military conflicts, in the Persian Gulf, in Lebanon and in the Caribbean raised market expectations of "safe-haven" flows into the dollar.

3. These circumstances prompted market professionals to buy dollars to cover their short-dollar positions established earlier on the anticipation of continued dollar declines. This adjustment of positions may have been sufficient to move the dollar up; thus far we have little concrete evidence that large-scale capital flows actually materialized.

4. In Germany, the Bundesbank apparently accepted the implications of the dollar's move on the German mark in view of the improvement in the German inflation picture relative to the late summer. The growth of the German money stock, while still somewhat above target, has slowed down in the last two months. However, the authorities were concerned about repercussions emanating from the problems of Schroeder, Meunchmeyer, Hengst & Company and intervened on several days, to calm the markets.

4. In Japan a package of measures was announced by the government in the latter half of October, aimed at stimulating the economy. The program included a 1/2 percentage point cut in the discount rate, accompanied by strong statements by the Bank of Japan that the yen would be defended. Subsequently, as the dollar firmed across the board, the Japanese were concerned that their currency was particularly vulnerable, in view of the

recent discount rate cut, and accordingly, intervened to support the yen. The Japanese authorities asked that the U.S. join them in corrdinated intervention, and, in response to this request the Desk also intervened on two trading days to purchase $29.6 million equivalent of yen, split evenly between the U.S. Treasury and the Federal Reserve.

E.M. Truman
Nov. 15, 1983

Briefing on the International Debt Situation

Mr. Chairman, the situation of the major international borrowers today is not easy to characterize. As in the case of the famous viewer of the glass of water, one can justify both pessimism and optimism. From the perspective of the half empty glass, eight of the ten largest borrowers among the OPEC and non-OPEC developing countries and the East European countries face serious external financing problems -- South Korea and Indonesia are the current exceptions. Four important borrowers -- Argentina, Brazil, Peru, and the Philippines are in the process of reconstructing their IMF-approved economic stabilization programs. In at least five countries -- Argentina, Brazil, Nigeria, the Philippines and Venezuela -- the process of establishing or reestablishing such programs coincides with a period of political transition. All of the borrowing countries are desperate for some real economic growth, but I would single out Chile, Mexico, and Venezuela in this regard.

From the perspective of the half full glass, a major international financial disaster has yet to occur. Several countries have made important progress in their stabilization programs during the past year; Chile, Mexico and Yugoslavia are three. I also think it is fair to say that, to date, each borrowing country is cooperating in its own way with the international banking community and with the international financial institutions.

Brazil remains at the top of everyone's worry list. However, after considerable delay, the Brazilian economic stabilization program appears to be about back on track. After the earlier defeat of a decree law on wage indexation, a modified law was approved last week by the Brazilian Congress. Because this new law offers less promise of wage restraint than the original law and because the rate of inflation in Brazil appears to be even higher than had been earlier projected -- advancing at an annual rate of about 225 percent over the first ten months of 1983 -- the Fund has asked for further modifications in the basic program; that is to say in monetary and fiscal policy. Agreement has apparently been reached on those modifications.

The banks are well on their way to obtaining a "critical mass" of commitments to provide the $6.5 billion in new money that is needed for the balance of 1983 and 1984, though there are many reluctant participants among the banks in this country and abroad. The governments appear to be proceeding a bit more slowly in reaching agreement on $2.5 billion in extraordinary export credits and guarantees to support the Brazilian program, but such an agreement will be reached. There will also be a Paris Club rescheduling of official debt, which may involve as much as $3 billion. The new Brazilian program is expected to go to the IMF Executive Board for approval before Thanksgiving, with a resumption of the IMF disbursements -- largely to pay off the BIS -- at the end of the month. The banks are expected to make $4.9 billion in gross disbursements before the end of the year, which will largely be used to clear up arrears and pay back bridge loans extended at the end of 1982.

Argentina is going through a bit of hiatus following its elections on October 30. After delaying the completion of their negotiations for much of the first eight months of the year, the banks were considerably more active in the months leading up to the elections, completing several pieces of the financial package. On the external side, Argentina has made some progress over the past year, reducing its arrears, reducing its current account deficit, and regularizing its external debt situation. However, inflation is running at more than 350 percent on a year-over-year basis, and the country is <u>de facto</u> out of compliance with its IMF-approved adjustment program. Despite the rather encouraging outcome to the recent elections in Argentina, it could well be many months before an acceptable economic program is established by the new government. Nevertheless, one has the sense that the situation in Argentina is generally understood and manageable.

In contrast, the seriousness of the economic and financial situation in the Philippines is, I believe, much less fully appreciated. The country is essentially out of reserves -- down to its last Agreement has not yet been reached on what steps are necessary to restore the operation of an IMF-approved economic stabilization program, though agreement may be reached with the IMF management this week. After agreement is reached with the IMF, the other external financing has to be worked out; the latest estimates of the gap to be filled are on the order of $2-1/2 to $3 billion. I would note that U.S. banks have a larger share of bank claims on the Philippines -- more than 45 percent -- than on any of the other major troubled borrowers with one exception; the share of claims on Chile is more than 50 percent.

I do not intend to bore you with an endless stream of cases, but I do want to say a few words about Mexico. Especially in light of the pessimism of a year ago, it is important to note the progress that Mexico has made in its economic stabilization program. Mexico has met, so far, all of the targets agreed with the IMF; we now expect a current account surplus of at least $2.5 billion this year -- in contrast with a $14 billion deficit two years ago -- and the inflation rate has declined to an annual rate of about 50 percent over the three months ending in October, in contrast with a rate of 175 percent early in the year. However, the rate should be somewhat higher in the last two months of the year. Mexico is working with the IMF on its program for 1984; it is expected to involve $3-1/2 to $4 billion in new money from the international commercial banks [at a lower spread than last year]; the Government of Mexico hopes that the program will also support a resumption of moderate growth and be consistent with a further reduction in inflation.

JLKichline
11/15/83

FOMC Briefing

The economic expansion continues to move along at a strong clip. The staff once again has raised its near-term projection of activity, expecting real growth in the current quarter to be around 6-1/2 percent annual rate, 1-1/2 percentage points higher than anticipated at the last meeting of the Committee. For the full year the economy seems likely to show real GNP growth of around 6-1/2 percent as well, typical performance for the first year of recovery. Although there has been some slowing in the pace of expansion since spring, it is much less than thought earlier and the levels of resource utilization are appreciably higher than had been projected.

The strong start on this quarter was indicated by the labor market report for October which showed an increase of 320,000 in payroll employment, the same monthly gain that has prevailed on average for the past half year. The unemployment rate fell 1/2 percentage point to 8.8 percent, in association with continued reduction of workers on layoff as well as a sharply reduced inflow to the labor force. Past experience with sizable drops in the unemployment rate and the labor force suggests we could find little further change in the unemployment rate over the next month or two, but this quarter and throughout 1984 the projected unemployment rate averages 0.4 percentage point lower than in the previous forecast.

Industrial output continues to rise strongly although at a somewhat reduced rate from the very large increases during the spring and summer months. This morning the industrial production index for October was released and it shows a gain of 0.8 percent--1/2 percent less than in the preceding month. Output increases were widespread and particularly notable for strength of business equipment sectors, while growth in output of construction supplies slackened and auto assemblies declined slightly--largely because of limited parts shortages.

The strength of production overall is being fueled by growth of orders to meet both rising current sales and anticipated sales. Inventory accumulation this quarter appears likely to be contributing considerably to growth of activity, and we expect it will be a major force next quarter as well. The forecast has inventories rising in line with sales after the first quarter, and if the pattern of accumulation projected does materialize it would be fairly typical of recovery periods, that is the contribution to activity peaks 4 or 5 quarters after the trough.

On the sales side, total retail sales rose about 1 percent in October, a few tenths less than the downward revised September figures. Auto sales picked up in October, especially for imported models, and other consumer goods registered solid gains. Consumer incomes have been increasing considerably, given the growth of employment, and retailers generally seem to expect good sales over the holiday period.

In the business fixed investment area, shipments and orders on average have been on the upswing. Outlays for equipment have been quite strong and there seems to be some revival of nonresidential construction, particularly commercial building. For the full year of 1983, business investment spending will likely show a rise of over 8 percent in real terms and we are forecasting a further rise of nearly 10 percent during 1984. This is a larger rise than now indicated by private surveys of spending intentions, but we believe the strength of final sales, rising capacity utilization, and large cash flows will induce firms to enlarge their investment programs.

The housing and export sectors by contrast are the areas tending to damp expansion of overall activity. Housing starts in September declined 14 percent from the elevated rate in the month earlier while building permits dropped further. Home sales, however, picked up a little in September and mortgage money from traditional and non-traditional sources seems plentiful at slightly lower rates than prevailed in late summer. In any event, we expect the current level of mortgage rates to be consistent with real estate activity in this quarter and next, little changed on balance from the reduced pace of September. Exports over the near term also are expected to be sluggish in view of the slow pace of recovery abroad and the continuing high level of the dollar in exchange markets.

The staff forecast overall basically has a contour similar to that presented at recent meetings, but the near term outlook now seems appreciably stronger than forecast previously. That additional strength is reflected in higher labor and capital resource utilization over the course of the forecast, and is also associated with a little less optimistic view on inflation prospects, as discussed in the presentation on inflation.

FOMC
SHAxilrod
November 14, 1983

For a year now, the federal funds rate range in the directive has remained at 6 to 10 percent, with effective use made of only the upper half of that range. The funds rate averaged near 9-1/4 percent in November '82, hit a low of around 8-1/2 percent in early 1983, and most recently has traded around 9-3/8 percent. That stability has been accompanied by a fairly substantial swing from rapid to relatively slow growth rates in narrow and broad monetary aggregates, with all of the aggregates now well within the longer-run ranges for 1983 adopted at mid-year. The stability in the funds rate has also accompanied a strong rebound in the economy--a rebound no doubt aided by the Committee's willingness to accommodate the considerable growth of M1 of late 1982 and the first half of 1983.

While money growth was rapid enough to encourage a strong cyclical resurgence of the economy, even in face of a rise in the demand for money to hold relative to GNP, there may still be an element of surprise in the strength of GNP if one focuses instead on the level of real interest rates. Many might have argued in late '82 and early '83 that a strong recovery required a lower level of real rates than we seemed to have had at the time, and by implication lower nominal rates. Not only was the funds rate high in real terms against the then current rate of inflation, but bond rates also seemed high in real terms against the presumed reduction in expected rates of inflation that had taken place. Treasury and corporate bonds did not vary substantially over the first half of 1983 from their 10-1/2 and 11-7/8 percent averages, respectively, of November '82.

The strength of the recovery may, of course, be taken as evidence that real rates were not in fact particularly high when compared with the real returns that might be anticipated by borrowers. A greater surge than anticipated in corporate profits may be one sign, for example, that real returns have been strong. In addition, the recovery has been led by consumer spending, much of which is not strongly influenced by interest rates--with disposable income fueled by a fiscal deficit that the Government necessarily finances irrespective of the level of interest rates. Finally, there appears to have been a pent-up demand for housing, with willing borrowers at mortgage rates in the 12-1/2 to 13-3/4 percent area.

One question that may naturally arise now, as the recovery approaches its second year, revolves around whether interest rates presently are or are not consonant with continued recovery at a reasonable pace without regeneration of excessive inflationary pressures. Nominal rates on corporate and Treasury bonds are currently about 3/4 to 1 percentage point above November '82 levels, while mortgage rates are a little lower.

Whether this means that there has been some added restraint is not an easy question, since the answer depends in part on the degree to which price expectations may have worsened and in part on whether borrowers' expectations of the real rate of return from investment have changed. Actual price performance has probably been better than would have been expected a year ago with so strong a recovery, but whether this has been translated into a view that inflationary pressures will remain damped into the future is not very clear. Some traditional signals of a worsening in inflationary attitudes are quite muted. The dollar has remained relatively firm on exchange markets, and precious metal prices have edged down over the past year. However, there has been some steepening in the upward tilt of the yield curve over the past year, but only a little. And a recent survey of market participants indicates that, although upward price expectations are no higher than a year ago, there have been small steady upward changes in price expectations since spring, suggesting that a revision in attitudes may be in process. In any event, continued strengthening of business spending plans, at current levels of nominal interest rates, is not inconsistent with a view that the present level of real market rates, whatever it may be, is not unduly restraining.

Probably the safest assumption is that present nominal interest rates imply real market rates that are not substantially higher than they were a year ago--and might just be in process of becoming lower if upward price expectations strengthen as the recovery continues into early next year at yet again an unexpectedly rapid pace. That sort of assumption would not seem to argue strongly for or against either an easing or tightening thrust of monetary policy at this time. If inflationary expectations were clearly worsening it would argue for a tightening of reserve availability, but as I noted evidence in that respect is not clear. On the other hand, if the real return to capital were falling because of reduced expectations of sales and profits at current prices, that would argue for some easing of pressures on bank reserve positions, but businesses do not now seem to be planning as if that is likely.

The monetary aggregates are generally useful guides to policy in such uncertain circumstances in the real economy. They too--being well within their longer-run range--are not suggestive of the need for much change in policy thrust over the near term. The weakness of M1 relative to the short-run September-to-December path adopted at the last meeting probably represents in part an unwinding of the earlier build-up in such money balances relative to GNP. While the drop of interest rates in the latter part of '82 no doubt contributed to that build-up, I still believe that diminished confidence in the economy also played a role. It seems likely to me that restoration of confidence in recent months has also contributed to the sizable rebound in M1 velocity in prospect for the current quarter. Thus, it is not very clear that the current weakness in M1--particularly with M2 and M3 in line with anticipations--should be interpreted as itself signaling a need for reduced reserve pressures.

I am afraid, Mr. Chairman, that we are still in a situation where neither the monetary aggregates, nor interest rates, nor the economy at large can be said to be giving unequivocal signals for policy. Which of the three alternatives for policy presented has appeal will in those circumstances necessarily depend on judgments about the whole economic situation--but, if I might venture, including a judgment at this time about whether we are or are not entering a period in which the risks of a resurgence in inflationary pressures are beginning to overbalance the risks that recovery will fall away to an unsatisfactory pace. Even if no change is made in the initial borrowing assumption for establishing reserve objectives, such a judgment about the risks of inflation relative to recovery would also influence the kind of response that the Committee would desire in face of unexpected variations in the monetary aggregates--symmetrical or asymmetrical; if asymmetrical, whether more sensitive to a strengthening or to a weakening in the aggregates.